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The Working Group has been informed that it may be feasible to have legislation in place by the end of the 2012-13 income year (including consultation on draft legislation), but understands that this would be subject to the Government's legislative drafting priorities. Introducing a prospective loss carry back would ease the pressure on completing other drafting by the end of 2012-13.

Table 3.2: Estimated cost of loss carry back

	Estimated costs ($ millions)					
	2011-12	2012-13	2013-14	2014-15	2015-16	Total
Phase in of loss carry back from 2013-14 with an initial carry back period of one year, an ongoing carry back period of two years and a $1 million cap	0	0	0	150	300	450
Loss carry back commencing in 2012-13 with two year carry back period with a $1 million cap	0	0	250	250	300	800

Conclusion

The Working Group considers it worthwhile for the Government to pursue loss carry back as a form of increased loss utilisation that provides many of the benefits of full loss refundability.

To manage the trade-off between targeting reforms to small and medium sized businesses and identifying required offsetting savings while still decreasing the bias against risk taking by companies, a two year carry back could be provided, limited by a quantitative cap of not less than $1 million and the franking account balance.

Consideration should be given to implementing loss carry back through a refundable tax offset to reduce the legislative, administrative and monitoring costs of the reforms.

Recommendation

Recommendation 2: The Working Group considers that loss carry back would be a worthwhile reform in the near term and could be implemented consistent with a model that:

- is limited to companies;
- provides a two-year loss carry back period on an ongoing basis;
- limits the amount of losses that can be carried back by applying a cap of not less than $1 million;
- limits the amount of refunds to a company's franking account balance; and
- is phased in from 2013-14 with an initial one year carry back period.

Chapter 4: Loss carry forward

Key points

- Loss carry forward departs from the benchmark of refundability:
  - The utilisation of carry forward losses is subject to 'continuity of ownership' and 'same business' rules.
  - The delay in accessing carry forward losses diminishes their value.

Loss integrity rules

- The continuity of ownership test (COT) disallows the use of carry forward losses when a company undergoes a substantial change in underlying ownership and the same business test (SBT) is applied when a company does not satisfy the COT.
- The COT and the SBT should operate together to balance two policy objectives: preventing tax driven trading in companies and ensuring the continued use of losses if a change of ownership occurred for commercial reasons.
- The COT performs a valuable function as a safeguard against loss trafficking. However, the SBT is not effective as a means for determining whether a change to a company's ownership was motivated by commercial considerations.
- Creating a more effective SBT would be expected to result in benefits to commercial behaviour and positive risk taking. The Working Group considers that identification of appropriate amendments to the SBT should be a priority for the Government.

Loss uplift

- The tax law allows losses to be carried forward indefinitely but only at their nominal amount. This deprives businesses of the time value of their losses.
- Allowing losses to be 'uplifted' so that they maintain their value would go some way to achieving symmetry in the treatment of taxable gains and losses.
- The case for uplifting revenue losses is stronger than the case for uplifting capital losses.
- Loss uplift would move the tax system closer to the benchmark of refundability and would be valued by some sections of the business community, particularly start-up businesses. Loss uplift should represent a lesser priority for Government than other reforms that would improve loss recoupment.

The treatment of carry forward losses departs from the benchmark of refundability

The Working Group has, in this report, considered the current tax treatment of losses against a benchmark of full refundability. Loss carry back is one means of moving closer to that benchmark. Targeted carry back could encourage risk taking and innovation and provide timely cash flow to businesses during economic downturns, acting as an automatic stabiliser.

In this chapter, we turn our attention to losses that are carried forward. There are two ways in which the treatment of carry forward losses departs from the benchmark of immediate refundability. First, losses carried forward can only be deducted against future taxable income if certain integrity rules are satisfied. Secondly, as losses can only be carried forward at their nominal amount, the value of losses to taxpayers erodes over time.

Overlaying both of these considerations is the fact that losses that are carried forward are often never able to be used. Even businesses that satisfy the integrity rules face the very real possibility of never generating sufficient future income to fully absorb the losses.

Facilitating adaptation and innovation should be paramount

There is no single, coherent policy that governs the tax treatment of carry forward losses. Our current system attempts to negotiate various competing policy considerations, not least of which is the impact the treatment of losses has on government revenues.

A key justification for loss integrity rules is that they remove incentives for 'tax driven' activities involving entities with losses. The challenge is how to frame these rules to discourage tax driven practices without impacting adversely on legitimate commercial activities.

The Working Group considers that the tax treatment of losses should reflect the broader policy that the tax system should not impede businesses from innovating or from adapting to changes in economic circumstances. Maintaining integrity in the tax system must be carefully balanced against the risk of stifling innovation.

The remainder of this chapter evaluates the current tax treatment of carry forward losses and suggests possible models for reform that reflect this broader policy consideration.

The loss integrity provisions have evolved over time

The rules governing the utilisation of tax losses have evolved considerably over time. Although tax losses can now be carried forward indefinitely, that is a relatively recent development. It was extended to primary producers in 1966 and was given general application in 1990. Before that time, most companies were only entitled to a deduction for losses from the preceding seven years. In the early decades of the federal income tax, losses could only be carried forward for four years.

Prior to 1944, the time limitations were the only restrictions that were imposed on the ability of companies to carry forward their tax losses to offset against future income. In 1944, the continuity of ownership test (COT) was established for private companies to address 'loss trafficking', that is, purchasing companies in order to gain a tax advantage from the carry forward losses.[18] Loss trafficking was described by the Treasurer at the time as the practice 'of buying up shares in practically defunct companies and then operating those companies for purposes other than those for which they were originally registered'.[19] The COT ensures that, broadly, a company cannot deduct its losses if there has been change in the identity of 50 per cent or more of its ultimate owners in the period since the loss was incurred.

The same business test (SBT) was first introduced in 1965 at a time when the COT requirements were being strengthened. It was intended to serve as a concession to the COT, aimed at ensuring that the COT did not interfere with bona fide attempts to take over, and rehabilitate, ailing businesses.[20]

For consolidated groups, even where the COT and SBT are satisfied, the available fraction rule generally applies to spread the use of the losses transferred into the consolidated group over time, referable to the asset base of the acquired entity. This recognises the potentially more diverse nature of businesses within a consolidated group and applies a formulaic base for utilising new losses coming into the consolidated group for integrity purposes.

Other integrity rules operate alongside the COT and SBT to target specific behaviour that could lead to loss duplication, whereby multiple losses stem from one economic loss. Overlaying all of these rules is the general anti-avoidance rule contained in Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936) and other rules to target behaviour aimed at reducing tax liabilities.[21]

A timeline of the changes to the loss integrity rules is set out at Appendix E.

The continuity of ownership test

The COT is satisfied if the same persons have more than 50 per cent of the voting power, rights to dividends and rights to capital distributions at all times during the ownership period.[22]

The ownership test period is generally the period between the start of the year in which the loss was incurred (the loss year) to the end of the income year in which the loss is sought to be recouped (the claim year). The point in time just before the COT is failed within the ownership test period is then used to compare the business to the SBT test period. A number of additional rules affect the application of the COT.

18 Asprey, K. W, 1975, Taxation Review Committee: Full report, Australian Government Publishing Service, Canberra, pp. 249 – 250 ('Asprey Review').

19 Asprey Review, p. 249.

20 See Treasurer's Second Reading Speech to Income Tax Assessment Bill 1965 (Cwth), cited in *Lilyvale Hotel Pty Ltd v Federal Commissioner of Taxation* 2009 ATC 9452.

21 Division 165 and 175 also include specific anti-avoidance provisions to protect the effectiveness of the COT by preventing share ownership being manipulated by arrangements aimed at reducing a tax liability (for example, by manipulating the ownership of shares to gain access to carried forward losses or injecting income into a business to utilise losses).

22 This is the 'primary' COT test. If one or more other companies beneficially owned shares, or interests in shares, in the company at any time during the ownership test period, then an alternative COT test which also examines voting, dividend and capital distribution rights to assess whether there has been a majority change in ownership where one or more companies beneficially owned shares or interest in shares in the company at any time during the ownership test period (subsection 165-12(6), 165-150(2), 165-155(2) and 165-160(2) of the ITAA 1997). A modified COT containing concessionary tracing rules that simplify the tracing of ownership interests is available for widely held companies and other types of companies (Division 166 of the ITAA 1997).

The same business test

A company satisfies the SBT if it carries on the same business in the claim year as it carried on immediately before it failed the COT. The SBT is intended to ensure continuity of the *whole of the business activities* carried on by the taxpayer just before it failed the COT and the *whole of the business activities* carried on by the taxpayer during the period of recoupment.[23]

However, a company will not satisfy the SBT if it:

- derives assessable income from a type of business of a kind that it did not carry on before the test time (new business test); or
- derives assessable income from a transaction of a kind that it had not previously entered into in the course of its business before the test time (new transaction test).

The new business test and new transaction test are described as 'negative tests' that look to see whether the *component* undertakings or enterprises and the transactions of the overall business are of the same kind as previously undertaken.[24]

Removing COT and SBT provides de facto loss refundability

The removal of the COT and SBT would move the treatment of losses closer to the benchmark of refundability. By removing the key restrictions on loss utilisation, the removal of the COT would increase the overall amount of losses that companies are able to put to use. Under the current system, losses incurred by a company that subsequently fails the COT and SBT are effectively trapped or wasted. The removal of the COT would also enhance the ability of company shareholders to be compensated for a company's tax losses by selling the shares at a price that reflects the value of the losses. This is illustrated in the following example.

Box 4.1 Example of loss trading

Anne injects equity of $100 in Company A (assume she is the only shareholder). During income year 1, the company makes a (revenue) loss of $100. Assume the company has poor prospects of earning future revenue against which it might use its loss. However, the loss potentially has a theoretical tax value of $30 to someone who could immediately use the loss against other income.

At the start of income year 2, Boris purchases Anne's shareholding for $20. Boris is willing to pay $20 for the shares because he is confident he can use the tax loss against other income in year 2. Anne will have made a capital loss on her shares of $80. Assuming she has other capital gains for the year, Anne will have realised some of the tax value of the revenue loss incurred by the company plus the value of the capital loss on her equity in Company A. Boris shields $100 of income from his other business in year 2 by using the carried-forward loss and terminates the business activities of company A.

As the example demonstrates, removing or relaxing the COT would, in theory, facilitate transactions to allow losses and profits in different businesses to be offset.

23 Australian Taxation Office, Taxation Ruling TR 1999/9, *Income tax: the operation of sections 165-13 and 165-210, paragraph 165-35(b), section 165-126 and section 165-132*, para 25. ('TR1999/9').

24 TR 1999/9, para 27.

The Working Group considered such an approach but concluded that it had disadvantages relative to other options for improving loss recoupment. The Working Group has ruled out recommending refundability of losses as a viable option for the foreseeable future because of its revenue impact. Creating a tolerance for de facto refundability through the trading in loss entities is also therefore ruled out by the Working Group.

Most comparable tax jurisdictions have a COT

The removal of COT would theoretically enable the trading in loss entities in cases where there may be no other legitimate commercial motivation for a share sale transaction. This issue is particularly significant when the treatment of losses in Australia is compared with comparable tax regimes.

The Working Group notes that OECD countries typically use a similar provision to the COT as one component of their loss integrity rules. In a recent OECD report, a COT was a feature of 16 of the 17 countries surveyed, with the required rate of continuity ranging from 30 to 75 per cent.[25]

The Working Group considers that introducing substantially less restrictive rules could create an incentive for multinational companies to bring their tax losses into Australia, putting greater pressure on transfer pricing rules and the thin capitalisation regime as revenue protection measures. This concern is shared by the OECD which noted that the opportunities for taxpayers to exploit differences among country rules are a source of tax risk.[26]

The key features of the loss integrity rules of the surveyed OECD member countries are summarised in the table below.

25 OECD, 2011, Corporate Loss Utilisation through Aggressive Tax Planning, Paris, pp. 34-6 ('Corporate Loss Utilisation through Aggressive Tax Planning').

26 Corporate Loss Utilisation Through Aggressive Tax Planning, p. 30.

Table 4.1 Restrictions on loss utilisation within OECD countries

Country	Restrictions	Exceptions
Australia	Change of ownership and activity	Ownership tracing concessions apply to widely held companies
Austria	Change of ownership and activity	Other (non-tax) considerations
Canada	Change of ownership and activity	Acquisition of corporations business activities
Denmark	Change of ownership and other criteria	Internal reorganisations
France	Change of activity	No
Germany	Change of ownership	Other (non-tax) considerations
Ireland	Change of ownership and activity	Internal reorganisations
Italy	Change of ownership and activity, mergers	Other (non-tax) considerations
Mexico	Change of ownership and activity, mergers	Inheritance, donation, internal reorganisation, merger and split off that are not considered alienations for tax purposes
Netherlands	Change of ownership and activity	Lack of tax avoidance motive
New Zealand	Change of ownership	Ownership tracing concessions internal reorganisations
Norway	Change of ownership and other criteria	Lack of tax avoidance motive
Spain	Change of ownership	Internal reorganisations
Sweden	Change of ownership	Internal reorganisations
Switzerland	Change of ownership and restart of activity	Financial restructurings
United Kingdom	Change of ownership and activity	Internal reorganisations
United States	Change of ownership	No

Source: Table adapted from OECD, Corporate Loss Utilisation through Aggressive Tax Planning (2011), p.34.

Changes to the SBT need to be considered

The SBT too narrowly prescribes the types of activities that a company can undertake without forfeiting its tax losses. In particular, the new business test and new transaction test (the negative tests) may create incentives for companies that have undergone a substantial ownership change to remain 'locked in' to an inefficient business model in order to avoid the risk of forfeiting those tax losses.

The Working Group considered three models for addressing deficiencies in the SBT:

- replacing it with a dominant purpose test;
- retaining the SBT but modifying it so that it better aligns with the modern business environment; and
- introducing a statutory drip-feed as a replacement, or alternative to, the same business test.

Each of these options is considered in detail below.

A dominant purpose test would be uncertain in its application

Under a dominant purpose test, carry forward tax losses would not be utilised where the tax losses were obtained through a transaction undertaken for the dominant purpose of obtaining a tax loss.

A dominant purpose test would require an assessment of the purpose of a transaction and companies may be uncertain about its application. Even where a dominant purpose test is established using objective criteria, it would require the development of new interpretative guidance on its operation. Also, the current SBT performs (or is intended to perform) a similar function to a dominant purpose test. Like a dominant purpose test, the SBT is essentially a mechanism for distinguishing between commercial and tax-driven transactions. As taxpayers, tax practitioners and administrators are familiar with the current regime, modifying the SBT to accord with the current economic environment is likely to involve lower transitional costs than the establishment of a new dominant purpose test.

Carrying on the same business is an appropriate measure of commerciality

Although there are deficiencies in the SBT in its current form, it is effective in reducing the risks to the revenue including from inappropriate trading in losses. There is value in retaining a same business test as a means of determining whether carry forward loss can be used. However, the SBT should be modified so that it better reflects the types of changes that are commonly made to businesses to restore or enhance profitability.

The Working Group considers that there is scope to achieve substantial improvements to the loss integrity provisions by recasting the language of the SBT. The key design consideration in developing indicators of similarity is that the rule should tolerate difference to the extent that it is consistent with genuine attempts to rehabilitate an ailing business. It should also have regard to the current dynamic business environment which requires businesses to change and adapt.

Removing the negative tests will better allow companies to adapt and change

One component of reforms to the SBT would be to remove the two negative tests. Where a company can meet the positive same business test, which signifies that the overarching business is the same, the company would be able to deduct previous tax losses from assessable income, despite a new transaction or new businesses generating assessable income. It would be expected that if the magnitude of the impact of the new business or new transaction was increased, then there would be a subsequent failure of the same business test.

The two negative tests are intended to prevent the injection of income into a company (moving a profitable arm of a business into the loss making company and shielding profits). However, the two negative tests do not depend on the existence of a purpose of tax avoidance for their operation and are overly restrictive.

It follows that, as a first step, recasting the SBT to more closely reflect modern business realities should involve removing the two restrictive negative tests, the new business test and new transaction test.

The positive limb of the SBT allows for organic growth and adaptation

In the context of the SBT, the word 'same' is interpreted to mean 'identical' and not merely 'similar'.[27] It is this aspect of the SBT that is the subject of most criticism. The Working Group considers that a better model for a modified SBT[28] is that it should facilitate, and not hinder, genuine and creative attempts to enhance profitability.

The Working Group notes that the test has generally been applied by the courts and the Tax Office with some regard to business reality. The identity requirement was first advanced by Gibbs J in *Avondale Motors (Parts) Pty Ltd v FC of T.*[29] In that judgment, it was stressed that a business could be the same notwithstanding that there are changes in the way it is carried on. It was contemplated that organic changes in a business were permissible.

The Working Group has also noted that statements by the Commissioner of Taxation show a similar tolerance for 'organic' changes:

> *The organic growth of a business through the adoption of new compatible operations will not ordinarily cause it to fail the same business test provided the business retains its identity; nor would discarding, in the ordinary way, portions of its old operations. But if, through a process of evolution a business changes its essential character, or there is a sudden and dramatic change in the business brought about by the either the acquisition or the loss of activities on a considerable scale a company may fail the test.*[30]

Instead of being replaced, the positive limb of the SBT could be retained as the primary test of whether a company that has failed COT should be able to use its losses. This test could ensure the appropriate treatment in most cases where the changes to the business came about because of genuine attempts to restore or enhance its profitability or to adapt to changes (or anticipated changes) to the business environment.

27 Australian Taxation Office, *Taxation Ruling TR 1999/9 Income Tax: the operation of section 165-13 and 165-210, paragraph 165-35(b), section 165-126 and section 165-132* ('TR 1999/9'), para. 13.

28 The term 'modified SBT' is used in a different sense here than in certain provisions of the ITAA 1997 relating to consolidated groups.

29 (1971) 124 CLR 97

30 TR 1999/9, para. 13.

A further advantage of retaining the positive limb of the SBT as part of any amended test is that the existing body of case law and ATO opinion would continue to be a valuable source of guidance to companies seeking certainty as to the continued availability of their losses.

The positive limb does not produce the appropriate outcome in all cases

In its consultation with the stakeholders, the Working Group has identified a range of situations where a company would fail the positive limb of the SBT even though the 'trigger' for the COT failure (such as a takeover) was motivated by genuine commercial considerations.

Having regard to these considerations, the Working Group consulted with stakeholders on a model for improving the same business test. Under this model, a company which fails the positive limb of the SBT would nevertheless pass the SBT if it carries on 'predominantly' or 'substantially' the same business having regard to a range of factors or indicators that would be set out in the law. These factors would reflect changes that are made to businesses for valid commercial reasons which might otherwise trigger a failure in the positive limb of the SBT. The factors would operate as alternatives, not cumulative requirements, and no particular weighting would be applied to one factor over another.

The Working Group considers the following factors could be incorporated into the modified test or be the basis for determining the meaning of 'predominantly' or 'substantially':

- the extent to which the same physical and intangible assets — including goodwill — are used for the purposes of producing assessable income;
- whether changes to the business are of a kind that might reasonably be expected to be adopted by a similarly placed business (for example, changes to the business to take advantage of unforeseen business opportunities); or
- the extent to which the company continues to generate a specified proportion of the total assessable income for the year from the same source.

The following examples illustrates how (and why), a modified SBT could lead to different outcomes than that provided for under the current law. The examples are extracted from the ATO's Taxation Ruling, TR 1999/9.

Box 4.2 Example of modified SBT in operation — Mammon Pty Ltd

'Mammon' (a company) carries on a gold mining operation on a tenement from which copper could also be produced. Copper prices are depressed so Mammon does not extract any copper. Mammon incurs large losses and changes hands, failing COT. Copper prices recover and Mammon invests in new plant, equipment and specialist staff to commence an operation of concentrating and selling copper concentrate to its gold mine.

Treatment under the current SBT	Treatment under the modified SBT
Under the current law, Mammon may pass SBT if it can demonstrate that the new copper concentrate business is comparatively insignificant in the extent of its overall business.	Under the modified SBT, significant weight would be attached to the fact the changes to Mammon's business are consistent with what might be expected of a similarly placed business in the circumstances.

Box 4.3 Example of modified SBT in operation — Restaurant Pty Ltd

Restaurant Pty Ltd (RPL) owns a high-end Japanese restaurant, catering to a wealthy clientele. The restaurant makes losses and changes hands, failing COT. RPL buys an Italian restaurant, which serves food that is 'notably cheap'. RPL continues to operate the Japanese restaurant but now also operates the Italian restaurant. No significant changes are made to the operations of either restaurant.

Treatment under the current SBT	Treatment under the modified SBT
Under the current law, RPL would fail the SBT because of the qualitative differences between a Japanese restaurant business and an Italian restaurant business.	Under the proposed test, RPL is able to demonstrate that it satisfies the test by having regard to other factors. In particular, although its operations have expanded, RPL is able to show continuity in the use of its physical and intangible assets that it owned immediately before its ownership changed.

Reforming the SBT for new losses only may increase complexity

In developing this report, the Working Group's focus has been on reform options that relieve the taxation burden on new investments. This emphasis suggests that reforms should be given prospective application. While this may be the case for other reforms discussed in this report, the situation with the proposal to modify the SBT may prove to be more complex.

Adopting a prospective application date for changes to the SBT would mean that a company that has existing losses as at the start date and then subsequently incurs further losses would be subject to two concurrent loss integrity regimes. This would lead to added complexity and compliance costs. The Working Group encourages the Government, in the event that it pursues reforms to the SBT, to give careful consideration to the appropriate application date. One option would be to apply the modified SBT to all losses of companies that would pass the existing SBT at the commencement of the new rules. Another option would be apply the modified SBT to companies that pass the COT as at that date.

A statutory drip-feed may complement a modified SBT

The interim report suggested that a drip-feed mechanism akin to the available fraction rule used for consolidation could replace the COT and SBT. The Working Group has concluded that the COT should be preserved as the primary safeguard against loss trafficking and does not consider a general drip-feed approach to be a viable option. However, an alternative reform to the loss integrity measures might be to retain the COT in its current form and adopt a drip-feed mechanism in place of the current SBT.

A drip-feed mechanism lacks a clear rationale other than that it would provide certainty that companies would eventually be able to utilise their tax losses and may provide a means of reducing the incentive for loss trading if a sufficiently low rate of utilisation was enforced.

The replacement of SBT with a drip-feed mechanism may result in some companies utilising tax losses more slowly than they would have under the current integrity rules. This may be considered inequitable and undesirable, especially by affected companies.

The adoption of a drip-feed mechanism raises a number of issues in terms of design and practical administration. One issue relates to the choice of an appropriate rate of utilisation. A single statutory rate applicable to all taxpayers would have the advantage of reducing complexity and being easier to administer. However, such a provision would be arbitrary and would not have proper regard to the taxpayer's individual circumstances. On the other hand, a rate that has regard to individual circumstances is likely to involve high compliance and administration costs. For example, it may require costly valuations to be undertaken.

A more pressing challenge in the design of a drip-feed mechanism is the need to ensure that it minimises the incentive for tax-motivated trading in companies with tax losses. The need to address 'loss trafficking' suggests that the rate of utilisation under a drip-feed should be relatively low. However, setting a low rate would increase the disadvantage to a company that would have passed the SBT.

In light of its concerns, the Working Group considers that SBT should not be replaced with a drip-feed mechanism. However, there may be merit in making a drip-feed available to companies on an 'opt-in' basis in conjunction with a simple 'continuity of business' rule. That is, a company which has failed COT could be allowed to make a binding election either to deduct losses at a statutory drip-feed rate (subject to there being a continuity of business) or to continue to be subject to the SBT. A company that so elected would enjoy more certainty as to its ability to utilise its losses and avoid the compliance costs associated with the same business test.

For ease of compliance and administration, a drip-feed mechanism offered as an alternative to the SBT could be calculated on single statutory rate applicable to all companies. A recovery rate of ten per cent per annum over ten years may be reasonable.

A modified SBT would assist start-up companies and companies facing a temporary shock

The worked examples described earlier illustrate the situations in which companies may benefit from a modified SBT.

Worked example 1: A start-up company

AAA will benefit from the changes to the SBT. AAA will gain more benefits the longer the period is between when it failed the COT and when it uses the loss, as there is a higher probability that AAA will change and not meet the current SBT.

In 2014-15, when AAA Pty Ltd is doing well but still has unrecouped tax losses, it receives an injection of equity from an additional shareholder (this results in a majority change in ownership). While AAA will fail COT, it is still carrying on the same business.

In 2015-16, in addition to producing algae plastic for plastic retailers the company also provides plastic direct to customers. There has also been a finding that algae can help in the teeth whitening process, and AAA starts exporting some of its stock of algae to overseas dentists. AAA has failed the COT but will pass the modified SBT because it has carried on predominantly the same business as it carried on immediately before the test time because:

- it uses the same physical and intangible assets (including goodwill) for the purposes of producing assessable income;
- it is reasonable to expect that a similarly placed business would take advantage of the increased demand for algae and sell off some of its excess supplies; or
- the company continues to generate a majority of its total assessable income for the year from selling the algae plastic.

Worked example 2: A company facing a temporary shock

Bread Pty Ltd will not benefit from the modifications to the SBT because it no longer has a tax loss. Bread Pty Ltd was able to access loss carry back and was provided a refund of $30,000 (the tax value of the loss).

Worked example 3: A company facing a sustained shock

XYZ Pty Ltd will not benefit from the modification of SBT because it is never able to use its losses.

Worked example 4: A company investing to upgrade its product line

Especial will not benefit in the short term from changes to the SBT as it would pass the existing integrity rules. The changes to the SBT would give Especial more flexibility to make changes to its business in the future.

Worked example 5: A terminal company

CCC Pty Ltd will not benefit from the modification of SBT because it is never able to use its losses.

Worked example 6: A consolidated group

The consolidated group will not benefit from the modification of SBT because the group is not in a tax loss position.

The Working Group has considered uplifting losses

The Business Tax Working Group's interim report identified that where losses are carried forward to be deducted against future income, the value of the tax loss carried forward erodes over time. As a result, the taxpayer will be deprived of the full value of the loss if it takes a number of years to generate sufficient income to offset the loss (assuming the integrity tests are met). This is a departure from the benchmark of refundability of tax losses.

A possible reform for the tax treatment of losses would therefore be to apply an uplift factor to tax losses as they are carried forward. The Working Group made it clear in its interim report that this would only apply to 'new' losses and not to the existing stock of losses. This is to ensure that reforms properly target removing the distortions on future decision making.[31]

Uplifting losses would move the treatment of losses closer to the immediate refundability benchmark. The uplift would preserve the value of the loss which is able to be used (deducted against future assessable income). It would therefore be of greatest benefit to those companies that make a tax loss but expect to generate taxable income in future years and are able to satisfy the relevant integrity tests.

31 Interim Report, paras 143-7.

An uplift would be of most benefit to a company that incurs significant expenditure while only generating limited income in its early years of operation, but subsequently becomes profitable. An uplift would allow such a company to shield a greater proportion of its future income against tax. Companies likely to fit this scenario may include start-ups[32], explorers and companies undertaking infrastructure projects.[33] For these companies, a loss uplift would increase the projected after-tax returns on the investment.

An uplift would also benefit a company which suffers a temporary shock as it would ensure that the value of tax losses is maintained in the period leading up to its return to profitability. This would also be relevant for those medium to large businesses with limited access to loss carry back because they have run down their franking account balances or their loss exceeds a quantitative cap.

Uplift would not provide a cash flow benefit to struggling businesses at the time they are incurring losses.

Loss uplift should be targeted and sustainable

Based on the benchmark of refundability, there is justification for a loss uplift that continues indefinitely at a rate that preserves the value of losses whilst having regard to each company's particular circumstances.

However, the Working Group considered that any uplift should be relatively simple to administer and sustainable in the long term.

The Working Group has consulted on a number of key factors in the design of a loss uplift. They are:

- the choice of the uplift rate;
- the scope of the uplift or the types of losses to which it would be available;
- the duration of the uplift; and
- simplicity of administration and compliance.

An uplift factor of the long term bond rate is appropriate

The interim report suggested that the long term (ten-year) government bond rate may be appropriate as the uplift rate. In the course of its consultation with stakeholders, the Working Group also considered alternative uplift rates. One view that emerged in consultation was that the most appropriate rate of uplift would be one which reflects each company's cost of capital. Another view is that the consumer price index (CPI) would most accurately ensure that the value of a loss is maintained.

Having considered the various options, the Working Group considers that the long-term government bond rate should be preferred. Alternatives which reflect the company's individual circumstances such as its cost of capital would be uncertain in their application and difficult to calculate. The CPI, while having the advantage of ease of calculation, does not accurately capture the time value of money. By contrast, the long-term bond rate can be viewed as the cost of the Government retaining

32 Noting that any eligible research and development (R&D) expenditure undertaken up such a company would already be refundable under the R&D tax incentive (provided the company has a turnover of less than $20 million). Such expenditure would therefore not form part of any tax loss the company carries forward.

33 In the 2011-12 Budget the Government announced that tax losses associated with designated infrastructure projects would be uplifted as they are carried forward and would not be subject to the COT and SBT rules.

the value of a loss as it is carried forward rather than immediately refunding it in the year it is incurred. That is, it treats the value of the tax loss like a government security, and offers the same return the taxpayer would earn on an alternative government security.

The Working Group acknowledges that a disadvantage of an uplift rate equal to the government bond rate is that it does not recognise the remaining risk that the losses may not ever able to be accessed (for example, in the event the business defaults or fails the COT or SBT). However, the Working Group believes that this rate achieves the appropriate balance between moving closer to the immediate refundability benchmark while maintaining simplicity and sustainability.

The long term government bond rate also has certain practical advantages. As it is a single rate applicable to all companies, it would impose a low cost of compliance and administration. It would also align with the Government's announcement in the 2011-12 Budget that tax losses from designated infrastructure projects can be uplifted at the long term Government bond rate.

Uplifting revenue losses is a higher priority

In light of its broader objectives and the need to ensure revenue neutrality, the Working Group does not regard the uplifting of capital losses as a priority. The approach that is adopted should be designed to assist businesses that, after a period of making losses, start (or resume) generating positive revenue flows rather than irregular capital profits. Companies in this position would not benefit from the uplifting of capital losses which will, in any event, be quarantined. This approach would align with business priorities because companies (particularly those in a net loss position) are less often in a position to realise capital gains against which to offset capital losses.

While there is some theoretical justification for applying uplift to capital losses, it is also arguable that it is inappropriate considering the nature of the capital gains tax (CGT) regime. A particular concern with uplifting capital losses is its consistency with 'quarantining', that is, the requirement that capital losses can only be offset against capital gains. The quarantining of capital gains and losses reflects the concessional nature of CGT, particularly the fact that CGT is levied on a realisation basis and can therefore be deferred indefinitely.

The Working Group understands that providing an uplift for capital losses may render quarantining ineffective in some cases where capital losses can be realised and uplifted. It would remove the disincentive to realise capital losses early where there are no realised capital gains against which they can be offset.

It is also noted that while the quarantining rules only allow capital losses to be offset against capital gains, it would not prevent uplifted revenue losses from being deducted from net capital gains. This would give companies some scope to shelter capital gains from tax by using uplifted revenue losses.

A time limited uplift is the most sustainable alternative

The Working Group considers, in the absence of a time limitation, that the impact of uplift to government revenue would be unsustainable in the medium to long term. The Working Group considered two alternatives for maintaining revenue neutrality while ensuring that it targets those businesses which would benefit most from the uplift.

One alternative for limiting the impact of loss uplift is to allow uplift for a fixed period, with the condition that losses would become unusable at the expiry of that period.

After consulting with stakeholders, the Working Group has concluded that an uplift that involves forfeiture of losses would not be welcomed by the business community and should not be adopted.

The Working Group considers that the forfeiture of losses would worsen the effects on investment of the existing asymmetric treatment of gains and losses.

The Working Group's preferred model is that tax losses should be able to be uplifted for a period of three to five years and then carried forward indefinitely without further uplift. A three to five year period would be of assistance to start-ups and other businesses that carry forward losses over a longer period. It would also assist those companies that are affected by the proposed quantitative cap or franking account limit on loss carry back.

Loss uplift is most suitable for incorporated businesses

In Chapter 3 of this report, the Working Group considered the arguments for and against extending loss carry back to unincorporated businesses, that is, sole traders, partnerships and trusts. It was concluded that, in light of administrative difficulties associated with extending carry back to non-corporate entities, and its limited benefits for partnerships and sole traders, it should initially be extended only to companies.

A proposal to implement loss uplift would require a similar examination of whether it should be extended to unincorporated business entities. This analysis gives rise to issues that largely mirror those that arise in relation to loss carry back.

Sole traders and partnerships allow for business losses to be offset against other income, so those entities may attach less value to uplift. Allowing loss uplift to trusts may present significant challenges in terms of design and implementation.

Loss uplift is a lesser priority for many businesses

The principal advantage of loss uplift is that it moves the treatment of losses closer to the benchmark of refundability. However, it would not improve loss recoupment or provide cash flow benefits to businesses at the time losses are incurred. In the context of the Government's broader objectives and the need to ensure revenue neutrality, loss uplift should represent a lower priority than other reforms outlined in this report.

As a result of consultation with stakeholders, the Working Group has concluded that, in general, businesses attach relatively less value to the ability to uplift losses. A number of stakeholders advised that uplift would not be a significant factor in determining whether to proceed with an investment. It was also noted that loss uplift would not provide additional cash flow to businesses undergoing a temporary downturn.

While it generally appears that businesses regard loss uplift as a lesser priority, this view is not universally shared. Loss uplift would be highly valued by businesses that endure lengthy periods of losses before achieving (or returning to) profitability. Businesses in this category include, notably, start-ups, explorers and stand-alone infrastructure projects.

Loss uplift would be of most benefit to start-up companies

The following examples illustrate the effects of loss uplift on each of the companies, with particular emphasis on the start-up company. The examples have been drafted to follow on from a loss carry back. An uplift rate of 5.75 per cent has been used in the calculations.

Worked example 1: A start-up company

If AAA Pty Ltd passes the loss recoupment rules, it would benefit from loss uplift as the uplift ensures that the tax value of the losses does not erode as it is carried forward. This is particularly beneficial for the start up as there may be considerable time between when the loss is made and when it is able to use the loss.

Year	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Assessable income	$0	$1,000,000	$5,000,000	$7,000,000	$8,000,000	$10,000,000
Expenses — excluding depreciation	($2,000,000)	($2,000,000)	($2,000,000)	($2,000,000)	($2,000,000)	($2,000,000)
Deductions — depreciation	($1,000,000)	($1,000,000)	($1,000,000)	($1,000,000)	($1,000,000)	($1,000,000)
Deductions — losses	$0	$0	($2,000,000)	($3,669,439)	$0	$0
Taxable income	($3,000,000)	($2,000,000)	$0	$330,561	$5,000,000	$7,000,000
Tax payable	*$0*	*$0*	*$0*	*$95,863*	*$1,450,000*	*$2,030,000*
Loss carried back	$0	$0	$0	$0	$0	$0
Carry back refund	*$0*	*$0*	*$0*	*$0*	*$0*	*$0*
Total value of carry forward losses	$3,000,000	$5,172,500	$3,469,919	$0	$0	$0
Uplifted carry forward amount	$3,172,500	$5,469,919	$3,669,439	$0	$0	$0

Worked example 2: A company facing a temporary shock

Bread Pty Ltd would not benefit from loss uplift because it no longer has a tax loss. Bread Pty Ltd was able to access loss carry back and was provided a refund of $174,000 (the tax value of the loss).

Year	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Assessable income	$2,000,000	$2,000,000	$2,000,000	$1,200,000	$1,800,000	$2,500,000
Expenses — excluding depreciation	($200,000)	($200,000)	($200,000)	($1,000,000)	($500,000)	($200,000)
Deductions — depreciation	($200,000)	($200,000)	($200,000)	($800,000)	($800,000)	($800,000)
Deductions — losses	$0	$0	$0	$0	$0	$0
Taxable income	$1,600,000	$1,600,000	$1,600,000	($600,000)	$500,000	$1,500,000
Tax payable	*$480,000*	*$464,000*	*$464,000*	*$0*	*$145,000*	*$435,000*
Loss carried back	$0	$0	$0	$600,000	$0	$0
Carry back refund	*$0*	*$0*	*$0*	*$174,000*	*$0*	*$0*
Total carry forward losses	$0	$0	$0	$0	$0	$0
Uplifted carry forward amount	$0	$0	$0	$0	$0	$0

Worked example 3: A company facing a sustained shock

XYZ Pty Ltd would benefit from loss uplift in the timeframe because it is able to uplift the $1.5 million loss that it is required to carry forward because it has reached the maximum carry back.

Year	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Assessable income	$3,000,000	$3,000,000	$2,000,000	$1,000,000	$500,000	$1,000,000
Expenses — excluding depreciation	($500,000)	($500,000)	($500,000)	($500,000)	($2,500,000)	($500,000)
Deductions — depreciation	($1,000,000)	($1,000,000)	($1,000,000)	($1,000,000)	$0	($100,000)
Deductions — losses	$0	$0	$0	$0	$0	($400,000)
Taxable income	$1,500,000	$1,500,000	$500,000	($500,000)	($2,000,000)	$0
Tax payable	*$450,000*	*$435,000*	*$145,000*	*$0*	*$0*	*$0*
Loss carried back	$0	$0	$0	$500,000	$500,000	$0
Carry back refund	*$0*	*$0*	*$0*	*$145,000*	*$145,000*	*$0*
Total carry forward loss	$0	$0	$0	$0	$1,500,000	$1,186,250
Uplifted carry forward amount	$0	$0	$0	$0	$1,586,250	$1,254,459

Worked example 4: A company investing to upgrade its product line

Especial would benefit from loss uplift to the extent that it cannot access carry back the full tax value of its losses in any one period and must carry forward remaining losses. The amounts that can be uplifted are:

- $4 million in 2014-15.
- $2.95 million in 2015-16.
- $800,000 in 2016-17.

In 2017-18 Especial returns to profit and is able to utilise its entire uplifted loss stock to reduce its taxable income.

Year	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Assessable income	$25,000,000	$25,000,000	$12,000,000	$15,000,000	$20,000,000	$30,000,000
Expenses — excluding depreciation	($18,000,000)	($19,000,000)	($16,100,000)	($18,000,000)	($19,000,000)	($18,000,000)
Deductions — depreciation	($750,000)	($750,000)	($900,000)	($950,000)	($1,800,000)	($1,800,000)
Deductions — losses	$0	$0	$0	$0	$0	($8,875,439)
Taxable income	$6,250,000	$5,250,000	($5,000,000)	($3,950,000)	($800,000)	$1,324,561
Tax payable	*$1,875,000*	*$1,522,500*	*$0*	*$0*	*$0*	*$384,123*
Loss carried back	$0	$0	$1,000,000	$1,000,000	$0	$0
Carry back refund	*$0*	*$0*	*$290,000*	*$290,000*	*$0*	*$0*
Total carry forward losses	$0	$0	$4,000,000	$7,180,000	$8,392,850	$0
Uplifted carry forward amount	$0	$0	$4,230,000	$7,592,850	$8,875,439	$0

Worked example 5: A terminal company

CCC Pty Ltd would not substantially benefit from loss uplift because it has enough losses to use in 2013-14 without the uplift and it is never able to use its final stock of losses at the end of 2014-15, even though the stock is larger under uplift.

Year	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Assessable income	$500,000	$5,000,000	$1,000,000	$0	$0	$0
Expenses — excluding depreciation	($3,000,000)	($2,000,000)	($500,000)	$0	$0	$0
Deductions — depreciation	($1,000,000)	($1,000,000)	($1,000,000)	$0	$0	$0
Deductions — losses	$0	($2,000,000)	$0	$0	$0	$0
Taxable income	($3,500,000)	$0	($500,000)	$0	$0	$0
Tax payable	*$0*	*$0*	*$0*	*$0*	*$0*	*$0*
Loss carried back	$0	$0	$0	$0	$0	$0
Carry back refund	*$0*	*$0*	*$0*	*$0*	*$0*	*$0*
Total carry forward loss	$3,500,000	$5,701,250	$6,529,072	$0	$0	$0
Uplifted carry forward amount	$3,701,250	$6,029,072	$6,904,494	$0	$0	$0

Worked example 6: A consolidated group

The consolidated group would not benefit from loss uplift because the group is not in a tax loss position.

Conclusion

There is significant scope for improvements in the way the tax treatment of carry forward losses impacts on business decision making. Losses have real value to businesses and are taken into account in investment decision making.

The effect of the same business test is that the advantages of making improvements to a business must be weighed against the disadvantage of its losses becoming unusable. The need for integrity in the treatment of tax losses must be tempered by consideration of the costs of locking businesses into inefficient structures. Subject to an evaluation of the costs and benefits of savings options, the integrity rules should, as a matter of priority, be changed to reflect modern business realities.

There is scope to improve incentives for businesses to innovate and adapt to change by reforming the SBT. The Working Group has considered a range of possible alternative approaches to reforming SBT that would better reflect the modern commercial environment. However, in the time available, we have not been able to settle on a preferred approach. We consider that the Government should undertake further work on possible reforms as a matter of priority.

Loss uplift is another potentially useful reform to the tax treatment of losses. Loss uplift is likely to have a positive impact on business risk taking and innovation but is a lower priority for Government in the short to medium term.

Recommendation

Recommendation 3: The Working Group recommends that the Government, as a matter of priority, undertake further analysis with a view to developing a model for reforming the same business test. One model for improving the existing loss integrity rules could involve a combination of:

- modifying the existing SBT so that it better aligns with the modern business environment; and
- introducing an alternative statutory drip-feed mechanism calculated on a straight line basis.

Appendix A: Business Tax Working Group — Terms of Reference

Objectives

1. The Working Group will make recommendations on how the Australian business tax system can be improved to make the most of the challenges and opportunities arising from transformations in the broader economic environment, including the patchwork economy.

2. The revenue neutral reforms to the business tax system will aim to increase productivity, while delivering tax relief to struggling businesses.

Scope

3. The Working Group will focus on reform options that relieve the taxation of new investment:

   3.1. in the near term, by reforming the tax treatment of business losses; and

   3.2. in the longer term, by reducing the corporate tax rate further or moving to a business expenditure tax system, particularly an allowance for corporate equity.

4. For its final reports, the Working Group will provide specific analysis of these business tax reform options, including:

   4.1. description of how these reforms options operate overseas and evidence on their effectiveness;

   4.2. potential priorities for reform, including transitional paths;

   4.3. worked examples of how these options would affect business taxpayers, including their financial and tax accounts;

   4.4. revenue integrity provisions, such as measures necessary to limit: the inappropriate claiming of tax losses; the equity allowance to new equity; and small and closely held businesses converting labour into business income;

   4.5. how the reform options integrate with the rest of the tax system now and in the future;

   4.6. impacts on national income and macroeconomic risks; and

   4.7. costings.

5. The working group will also identify a range of off-setting budget savings from existing Commonwealth business taxation (or spending) measures. Changes to the GST should not be considered.

   5.1. The savings to be generated by the particular options will be costed by the Treasury in accordance with the budget rules.

6. In developing its recommendations, the Working Group should have regard to the report of the Australia's Future Tax System Review and relevant international experience and expertise.

Timing

7. The Working Group is required to provide the Treasurer with:

   7.1. an initial report on the proposed directions for improving the tax treatment of losses and offsetting savings in mid-November 2011;

   7.2. a final report on the treatment of losses and the offsetting savings in March 2012; and

   7.3. a further report on longer-term business tax reform options and offsetting savings by the end of 2012.

Consultation

8. For its final reports, the Working Group should consult widely with industry and the broader community.

9. The Working Group may establish technical sub-groups to consider specific issues or seek input from other sources of expert advice.

Support

10. The Working Group will be supported by a Secretariat within Treasury.

APPENDIX B: POSSIBLE BUSINESS TAX SAVINGS

Treasury provided the Working Group with information on possible business tax savings largely drawn from the Tax Expenditures Statement. In the time available the Working Group has not had the opportunity to fully consider the benefits and risks of one or more or a combination of savings options and the Working Group has not been able to consult widely on the extent of any adverse impacts.

Statutory effective life caps

A substantial expenditure in the business tax system is the provision of statutory effective life caps[34] for certain depreciating assets used in certain industries. In particular, statutory caps are available in the oil and gas, petroleum, agricultural and transport industries. The application of the statutory cap on the effective life of depreciating assets means that the effective tax rate applying to each of these industries is kept below the statutory rate. Assets with statutory effective life caps generally have very long effective lives such that even a statutory effective life cap of 15-20 years is a concession in some cases.

Accelerated depreciation arrangements for all other assets were removed as part of the reforms following the Review of Business Taxation.[35] Statutory effective life caps were introduced in 2002 to maintain accelerated depreciation for certain depreciating assets amid concerns that the extension of effective lives would have wide-ranging effects on investment decisions.

In consultation sessions the Working Group has discussed the application of statutory caps in the oil and gas industry. Possible savings generated from the removal of statutory caps would be influenced by how the removal was applied. For example, the level of savings would be influenced by the start date and whether the changes applied to assets installed ready for use after the start date or whether the current statutory caps would still be used where contracts for assets had been entered into before the start date despite assets not being installed ready for use.

Immediate deduction for exploration and prospecting

The current tax law allows an immediate deduction for certain expenditure on exploration or prospecting for minerals which allows the expenditure to be deductible outright in the year in which it is incurred.[36] Examples of deductible expenditure include transport, materials, labour and administrative costs incurred in carrying out exploration or prospecting activities. The tax law also allows an immediate deduction for the cost of depreciating assets that are first used in exploration or prospecting.[37]

Treasury has costed the removal of the immediate deduction for exploration and prospecting expenditure, with effect from the announcement of the 2012-13 Budget, as achieving savings of $1200 million over the forward estimates period. Alternatively, the removal of the immediate deduction for the cost of depreciating assets first used in exploration or prospecting from the announcement of the 2012-13 Budget would achieve savings of $900 million over the forward estimates period.

34 That is, the life of the asset for tax depreciation purposes is shorter than the actual economic depreciation of the asset.
35 Review of Business Taxation, 1999, *Review of Business Taxation: A tax system redesigned*, Canberra.
36 Under section 40-730 of the ITAA 1997.
37 Under subsection 40-80(1) of the ITAA 1997.

Possible savings generated from the removal of the immediate deductions represent the upper bound for potential savings under those options. Phasing in the removal of either of the immediate deductions would reduce the potential savings achieved. It is also important to note that savings achieved would be influenced by the start date.

The R&D non-refundable tax incentive

The R&D tax incentive replaced the R&D tax concession from 1 July 2011 to provide a targeted tax offset to encourage certain companies to conduct R&D activities that benefit Australia. The R&D tax incentive provides a 40 per cent non-refundable tax offset for eligible entities with a turnover of $20 million or more.

Treasury costings indicate that a reduction in the rate of the non-refundable tax offset from 40 per cent to 37.5 per cent, with effect from 1 July 2013, would achieve savings of $500 million over the forward estimates period.

A second approach could leave the rate unchanged but impose a cut-off turnover threshold. Treasury costings indicate that imposing an upper turnover threshold at a relatively high level of $30 billion would provide savings of around $150 million per year. Introducing such a threshold would be expected to affect a small number of very large companies with very large R&D spends.

A third approach would be to impose a substantial annual cap (for example, at least $100 million) on the amount of R&D expenditure that would attract the 40 per cent non-refundable tax offset. The size of the cap needed to achieve a particular savings target is yet to be costed by Treasury.

Thin capitalisation rules

The current thin capitalisation regime is designed to ensure that multinationals do not allocate an excessive amount of debt to their Australian operations. The regime operates by disallowing a proportion of otherwise deductible borrowing expenses where the debt allocated to Australian operations exceeds certain limits. Without robust thin capitalisation rules, improved loss recoupment arrangements could increase the incentives of multinationals to shift debt and their related deductions to Australia providing them with a competitive advantage over purely domestic firms (or firms with truly independent financing arrangements).

The current thin capitalisation regime consists of a number of debt tests or limits. These limits require Australian entities under the regime to calculate the maximum debt deductions allowed to be claimed on their Australian operations, based on the underlying Australian assets involved. If the Australian operations have debt deductions above the maximum allowed (the debt limit that the entity elects to use for its operations), the excess deductions will be denied. Conversely, where the debt deductions of the entity's Australian operations do not exceed the maximum allowed, none of these deductions will be denied.

The following possible changes to the thin capitalisation rules were used as the basis for consultation:

- removing the arm's length debt test (for general entities and non-bank financial entities) and the arm's length minimum capital amount (for banks) from the domestic law;
- reducing the safe harbour maximum debt limit for general entities from 75 per cent to 60 per cent on a debt-to-total assets basis (or from 3:1 to a 1.5:1 debt to equity basis);
- reducing the worldwide gearing ratio for general entities and non-bank financial entities from 120 per cent to 100 per cent; and

- increasing the worldwide capital ratio for banks from 80 per cent to 100 per cent.

Treasury's costing of the savings that might be realised through these changes (approximately $300 million per year) was criticised as being too low by stakeholders.

APPENDIX C: CONSULTATION SUMMARY

In accordance with the terms of reference, in arriving at this final report the Working Group has provided the Treasurer an interim report and conducted a mix of public and confidential consultation.

Public submissions made in response to the interim report

The Working Group's interim report on the tax treatment of losses was publicly released on 11 December 2011. The interim report explored the tax treatment of losses in Australia, in particular how this treatment affects Australian businesses' ability to respond to changes in the local economy and developments abroad.

The Working Group invited written submissions from businesses and the wider community on the issues and ideas discussed in the interim report. To assist interested parties in making submissions, some framing questions were provided in a separate consultation guide.

Submissions were requested by 3 February 2012. The Working Group received a total of 24 submissions in response to the interim report including two confidential submissions. Public submissions were received from the following organisations and individuals:

Association of Mining and Exploration Companies
Australand Property Group
Australian Chamber of Commerce and Industry
Australian Financial Markets Association
Associate Professor Dale Boccabella
BDO
BusinessSA
Corporate Tax Association
CPA Australia
Ernst and Young
Grant Thornton
Institute of Chartered Accountants in Australia
Institute of Public Accountants
Master Builders Australia
National Tourism Alliance
Penam Partners
Property Council of Australia
Real Estate Institute of Australia
The Tax Institute
Tourism and Transport Forum
Tourism Accommodation Australia
Yarrawa Management Pty Ltd

The Working Group's interim report on the tax treatment of losses was intended to elicit stakeholder views on reform priorities in this area and help us gain a better understanding of how the current system affects business decision making.

Confidential consultation on possible reforms and savings options

In light of the feedback we received in response to the interim report, the Working Group started to develop more specific reform proposals that could be costed by Treasury. Only in light of this information was the Working Group able to focus on the potential savings task.

Over the course of March 2012, representatives of the Working Group conducted meetings with stakeholders in Melbourne, Sydney, Brisbane and Perth.

The stakeholders consulted were a mix of representative bodies and individual businesses. In light of the Working Group's focus on the corporate tax loss rules, in each location there was an opportunity for members of the Corporate Tax Association to meet with representatives of the Working Group.

The Working Group asked for these meetings to be conducted on a confidential basis to allow discussions between the Working Group and participants to be as open as possible. Given the confidential nature of the meetings, the Working Group does not propose to name all of those involved in the process.

APPENDIX D: INTERNATIONAL LOSS TREATMENT

Country	Loss carry back	Restrictions and exceptions	Loss carry forward	Restrictions and exceptions
Australia	No	Not applicable.	Indefinite	Change of ownership and activity. • Change of ownership considered as more than a 50 per cent change in voting power, dividend or capital rights. • Ownership tracing concessions apply to widely held companies. • Carve out for companies with a change of ownership that have maintained the same business activity. *Unincorporated businesses.* Loss carry forward permitted for unincorporated businesses. • Losses must be utilised at first opportunity. • Losses may offset non-business income, subject to various restrictions.
Austria	No	Not applicable.	Indefinite	Change of ownership and activity. • Losses can only be carried forward against 75 per cent of current annual income. • Losses will not be transferable if there is a change in the economic identity of the company combined with a modification of the organisational structure, unless the intentions of such modifications are to preserve employment. • Losses will be forfeited in the case of a merger, if the assets through which the losses were originated are not included in the arrangement. *Unincorporated businesses.* Loss carry forward permitted for unincorporated businesses and may be deducted against non-business income.

Country	Loss carry back	Restrictions and exceptions	Loss carry forward	Restrictions and exceptions
Canada	3 years	*Unincorporated businesses.* Loss carry back permitted for unincorporated businesses.	20 years	Change of ownership and activity. • A change of ownership takes place if there is more than a 50 per cent change in share capital or voting power. • Continuation of 'similar' business activities is generally interpreted as 'of the same general nature or character', and considers factors such as the location of the business carried on before and after the ownership change, nature of the business, nature of the income-producing assets, name of the business, existence of period/s of dormancy, extent to which the original business activities now constitute the income-producing activities of the successor company. • No explicit rules to allow the transfer of losses within a consolidated group. *Unincorporated businesses.* Loss carry forward permitted for unincorporated businesses and may generally be deducted against other forms of taxable income.
Denmark	No	Not applicable.	Indefinite	Change of ownership. • A change of ownership takes place if there is a more than 50 per cent change in share capital or voting power. • Change of ownership rules do not apply to financial enterprises, including banks. • Restrictions on carry forward of losses do not apply for group internal restructurings. *Unincorporated businesses.* Carry-forward of losses permitted for unincorporated businesses and may be deducted against personal income.
France	1 year	Loss carry back period recently reduced from 3 years to 1 year. Loss carry back amount capped at €1 million. Net operating losses that exceed this €1 million cap may offset taxable income in a subsequent year, but will be limited to 60 per cent of that year's taxable income.	Indefinite	Change of activity. • Only 60 per cent of profits in excess of €1million may be offset against losses carried forward. • Losses will be forfeited if there is a "thorough" change in the business or activity of the loss company, regardless of its ownership.

Country	Loss carry back	Restrictions and exceptions	Loss carry forward	Restrictions and exceptions
Germany	1 year	Loss carry back amount capped at €0.5 million. *Unincorporated businesses.* Extends to sole traders and partnerships.	Indefinite	Change of ownership. • Only €1million plus 60 per cent of the current year profits in excess of this amount will be offset against tax loss carry forward. • Losses will be forfeited in cases where the loss-incurring entity owns less than 50 per cent of shares within five years of the change of ownership and also if predominantly new business assets are injected into such an entity. • A partial forfeiture of losses will result from a 25-50 per cent of shares in a corporation are acquired. • Exceptions exist for other (non-tax) considerations, including allowances for companies that restructured in order to rescue a loss-making company. *Unincorporated businesses.* Loss carry forward permitted for unincorporated businesses and may be deducted from other forms of taxable income, subject to special restrictions.
Ireland	1 year	Business losses incurred in the year of trade being permanently discontinued may be carried-back against profits of the same trade for the previous 3 years. *Unincorporated businesses.* Loss carry back permitted for unincorporated businesses.	Indefinite	Change of ownership and activity. • Change of ownership requires that the same persons that controlled trade in the 1 year before the change in ownership continue to hold a minimum 75 per cent share in trade within the two years after the transfer of ownership. • Restrictions on loss carry forward do not apply for group internal restructurings. • Activity test requires continuation in the nature of the original company's trade including the type of goods, services or facilities provided and the customers, outlets or markets. *Unincorporated businesses.* Loss carry forward permitted for unincorporated businesses, however may only offset profits from the same trade.

Country	Loss carry back	Restrictions and exceptions	Loss carry forward	Restrictions and exceptions
Italy	No	Not applicable.	Indefinite	Change of ownership and activity. • Change of ownership takes place if there is more than a 50 per cent change in the ownership of the loss entity. Ownership is calculated by multiplying the acquired corporation's stock by the long-term exempt bond rate. • An equity test[38] and vitality test[39] must be passed to be able to use pre-existing losses in the case of a merger. • All ordinary losses incurred after the first three years of business activity are only permitted to offset 80 per cent of subsequent taxable income. • Loss carry forward is forfeited if a change in the main business activity of the company occurs within two years following or preceding the change of ownership. *Unincorporated businesses.* Loss carry forward permitted for unincorporated businesses, however ring-fencing rules deny offsetting against non-business income.

38 Net equity test: allows carry-forward of losses within the limit of the amount of net equity resulting from the balance sheet for the financial year preceding the shareholder resolution approving the merger.

39 Vitality test: the transferring entity's profit and loss account for the financial year prior to the resolution of the merger must show that revenues and labour costs are higher than 40 per cent of the average of the two prior financial years.

Country	Loss carry back	Restrictions and exceptions	Loss carry forward	Restrictions and exceptions
Mexico	No	Not applicable.	10 years	Change of ownership and activity. • A change of ownership occurs when 50 per cent of the voting shares of a company changes. • Change of ownership rules may not apply in circumstances of inheritance, donation, internal reorganisation, merger and split off that are not considered alienations for tax purposes. • Where a merger is carried out, only the merging company can carry forward the losses it has at that moment, and only for purposes of using them against profits derived from the same trade that originated the losses. • After a change of ownership and activity, a loss carry-forward can only offset profits from the same type of activity that generated the losses if the sum of the receipts derived during the last three years is less than the accumulated losses of the company. *Unincorporated businesses.* Loss carry-forward permitted for unincorporated businesses, however ring-fencing rules deny their offsetting against non-business income.
Netherlands	1 year	Optional 3 year loss carry back for losses from 2009, 2010 and 2011, for remaining losses a loss carry-forward of 6 years (as opposed to 9 years) is allowed. Loss carry back amount capped at €1 million.	9 years	Change of ownership and activity. • Carry forward is denied if more than 30 per cent of original shareholders have disposed of their shares. Broadly, this rule does not apply if the new shareholders already held one third of the shares. • Exceptions permitted in cases where a lack of tax avoidance motive is demonstrated. • Additional restrictions are applicable in the case of holding and group financing companies.
New Zealand	No	Not applicable.	Indefinite	Change of ownership. • A change of ownership occurs if more than 50 per cent of voting rights changes in one year. Ownership tracing concessions may apply. • Losses can be carried forward after an internal group restructuring if continuity and commonality requirements are met. • Loss carry-forward permitted for

Country	Loss carry back	Restrictions and exceptions	Loss carry forward	Restrictions and exceptions
				unincorporated businesses and may be deducted against other forms of taxable income.
Norway	No	In the case of liquidation a two-year loss carry back is allowed. In addition, a temporary 2 year loss carry back has been introduced for losses from 2008 and 2009. Loss carry back for these years is capped at NOK 20 million per annum.	Indefinite	Change of ownership. • Pre-existing losses will not be recognised in mergers if one of the merging firms already possesses losses, and the merging arrangement is therefore likely to be underpinned by tax-avoidance motives. • Special rules apply to the petroleum sector: carry forward of losses with interest; tax value of losses refundable on cessation of activity; tax value of losses due to exploration refundable annually. *Unincorporated businesses.* Loss carry-forward permitted for unincorporated businesses.
Spain	No	Not applicable.	15 years	Change of ownership. • As of August 2011, temporary changes were enacted for loss carry-forward utilisation. • For the years 2011, 2012 and 2012, a company with a turnover (that is, sales) between €20-60 million is only allowed to offset up to 75 per cent of its taxable income with net operating losses being carried forward • A company with a turnover in excess of €60 million may only offset 50 per cent of its taxable income. • The original 15 year carry-forward period was extended to 18 years. • For newly established companies, the carry-forward period commences as from the first tax year in which profits are made. • Restrictions exist mainly in cases of change of control of dormant companies. • Restrictions on carry-forward of losses do not apply for group internal restructurings. *Unincorporated businesses.* Unincorporated businesses may carry-forward losses against other sources of income under Personal Income Tax regulations.

Country	Loss carry back	Restrictions and exceptions	Loss carry forward	Restrictions and exceptions
Sweden	No	Not applicable.	Indefinite	Change of ownership. • A change of ownership occurs if there is a change of controlling interest of more than 50 per cent. • After an acquisition of control of a company, the loss carry-forward is deductable only up to 200 per cent of the acquisition price and it is not possible to use the loss carry-forward of the acquired company through group contributions during the first five years after the change of ownership. • Restrictions on carry-forward of losses do not apply for group internal restructurings. *Unincorporated businesses.* Loss carry-forward permitted for unincorporated businesses.
Switzerland	No	One canton (Thurgau) allows a 1 year loss carry back for local taxes.	7 years	Change of ownership and restart of activity. • No restrictions following change of ownership with the exception of special cases, such as the transfer of shares in a non-active company. • Financial restructurings may overcome change of ownership restrictions. *Unincorporated businesses.* Loss carry-forward permitted for unincorporated businesses.
United Kingdom	1 year	Generally one year, however 3 years was permitted for 2008-09 losses. If a trade is permanently discontinued certain losses may be carried back against profits of the same trade for the previous 3 years. Carry back only allowed if the organisation was carrying on the same trade at some point in the preceding 12 months. *Unincorporated businesses.* Loss carry back is permitted for unincorporated businesses.	Indefinite	Change of ownership and activity. • There is a change in ownership if more than 50 per cent of a company's ordinary share capital changes hands. • Losses may only be carried forward against profits of the same trade. • Internal reorganisations may overcome change of ownership restrictions. *Unincorporated businesses.* Loss carry-forward permitted for unincorporated businesses.

Country	Loss carry back	Restrictions and exceptions	Loss carry forward	Restrictions and exceptions
United States	2 years	Generally 2 years, however due to the global financial crisis, an extension of 5 years permitted for 2008-09 losses. *Unincorporated businesses.* Loss carry back permitted for unincorporated businesses.	20 years	Change of ownership and activity. • Change in ownership occurs if, as a result of changes in the stock of ownership by '5 per cent shareholders' or other reorganisations, the percentage of the corporation's stock owned by those 5 per cent shareholders increases by more than 50 percentage points over the lowest percentage of stock owned by those shareholders at any time during the prior three-year testing period. • Some losses can be utilised if some of the old corporation's historic business is continued. *Unincorporated businesses.* Loss carry-forward permitted for unincorporated businesses.

Source: Table adapted from OECD, Corporate Loss Utilisation through Aggressive Tax Planning (2011), p.34.

APPENDIX E: TIMELINE OF THE CHANGES TO THE LOSS INTEGRITY PROVISIONS

1922-1934	Preceding 4 years of losses can be deducted against income (including exempt income) in the order they occurred.
1944	COT introduced for private companies, no loss will be an allowable deduction unless 25 per cent of the shares were held by the same person at both the time the loss was made and the time of deduction.
1947	Carry forward period of 7 years introduced for primary producers.
1950	7 year carry forward rule extended to all private companies.
1964	COT rules extended to public companies. COT threshold increased to not less than 40 per cent beneficial ownership based on voting power, rights to dividends and rights to capital and applied to ALL companies.
1965	SBT introduced as a concession where there is a COT failure.
1966	The limit of seven years on the carry-forward period for deductions of prior year losses is removed for primary producers.
1973	COT threshold increased to more than 50 per cent beneficial ownership.
1973	A control test and income injection test introduced to add integrity to COT. The COT and SBT are extended to apply to the utilisation of bad debts.
1984	Group loss transfers introduced. Advent of consolidation saw the scope of these provisions greatly reduced.
1985	CGT introduced. COT and SBT must be satisfied to apply prior year capital losses.
1986	Foreign losses no longer offsettable against Australian income, domestic losses no longer offsettable against foreign income.
1990	Unlimited carry-forward losses introduced.
1995	Trust loss rules take effect. Trust loss rules do not apply to the recoupment of net capital losses.
1997	Modifications made to COT to make it easier for certain public companies to recoup losses — Division 166.
1999	As a precursor to consolidation, 'Business Tax Reform' introduces a series of integrity rules to strengthen COT and reduce the opportunity for capital loss creation.
2002	Consolidation introduced. Measures included loss transfer rules, modifications to COT and SBT and recoupment restrictions, and available fraction test. Normal COT and SBT apply following transfer of the loss into consolidated group.